



STATE OF MICHIGAN

JENNIFER M. GRANHOLM
GOVERNOR

OFFICE OF THE STATE BUDGET
LANSING

MARY A. LANNOYE
DIRECTOR

December 23, 2003

The Honorable Jennifer M. Granholm, Governor
Members of the Legislature
People of the State of Michigan

As required by Article 9, Section 21, of the State Constitution and Section 494, Public Act 431 of 1984, as amended, we are pleased to submit the *State of Michigan Comprehensive Annual Financial Report* (SOMCAFR) for the fiscal year ended September 30, 2003.

INTRODUCTION TO THE REPORT

Responsibility: The Office of the State Budget, Office of Financial Management, prepares the SOMCAFR and is responsible for both the accuracy of the data and the completeness and fairness of the presentation, including disclosures. To the best of our knowledge and belief, the information contained in the SOMCAFR is accurate in all material respects and reported in a manner that fairly presents the financial position and results of operations of the State primary government and component units for which it is financially accountable. All disclosures necessary to enable the reader to gain a reasonable understanding of the State's financial affairs have been included.

Adherence to Generally Accepted Accounting Principles: As required by State statute, we have prepared the financial statements contained in the SOMCAFR in accordance with generally accepted accounting principles (GAAP) applicable to state and local governments, as promulgated by the Governmental Accounting Standards Board (GASB). The State also voluntarily follows the recommendations of the Government Finance Officers Association of the United States and Canada (GFOA) for the contents of government financial reports, and participates in the GFOA's review program for the Certificate of Achievement for Excellence in Financial Reporting.

Report: The SOMCAFR is divided into three major sections: introductory, financial, and statistical:

- The introductory section includes this letter, the State's organization chart, and the list of principal officials.
- The financial section includes: the independent auditor's report on the Basic Financial Statements; Management's Discussion and Analysis (MD&A) which provide an introduction, overview, and analysis to the Basic Financial Statements; the Basic Financial Statements, which present the

government-wide financial statements and fund financial statements for governmental funds, proprietary funds, fiduciary funds, and component units, together with footnotes to the Basic Financial Statements; Required Supplementary Information other than MD&A, which presents budgetary comparison schedules and information about infrastructure assets; and the supplemental financial data which includes the combining financial statements and schedules.

- The statistical section includes such items as trend information, information on debt levels, and other selected economic and statistical data.

Internal Control Structure: The Office of the State Budget is responsible for the overall operation of the State's central accounting system and for establishing and maintaining the State's internal control structure. All financial transactions of the State primary government are recorded in the central accounting system, except for the Michigan Unemployment Compensation Funds, the State Employees' Deferred Compensation Funds, the State Employees' Defined Contribution Retirement Fund, and the Michigan Education Savings Program. Many of the essential control features are decentralized, such as the preparation and entry of expenditure transactions into the central accounting system. Consequently, the Office of the State Budget relies upon the controls in place at the various State departments and agencies. The Management and Budget Act (Section 18.1483 – 18.1489 of the *Michigan Compiled Laws*) requires the head of each principal department to establish and maintain an internal accounting and administrative control system. The Act also requires the heads of each principal department to report biennially on any material inadequacy or weakness discovered in connection with the evaluation of their system. The *"Evaluation of Internal Controls – A General Framework and System of Reporting"*, developed in consultation with the Office of the Auditor General, provides the required guidance associated with the evaluation of internal controls in Michigan State government. The framework for internal controls has been designed to provide reasonable rather than absolute assurance that the financial statements are free from material misstatement.

The Management and Budget Act requires each principal department to appoint an internal auditor and to maintain adequate internal control systems. Each department is also required to periodically report to the Governor on the

adequacy of its internal accounting and administrative control systems and, if any material weaknesses exist, to provide corrective action plans and time schedules for addressing such weaknesses. This reporting is required on or before May 1 of each odd numbered year, effective as of the preceding October 1.

The discretely presented component units generally operate outside the State's central accounting system and are responsible for establishing and maintaining their own separate internal control structures.

Independent Auditors: The Office of the Auditor General (OAG) is the principal auditor of the SOMCAFR. The OAG also relies on the opinions of outside public accounting firms, particularly for component unit financial statements (such as the Michigan State Housing Development Authority and 10 of the State's universities), the larger pension and other employee benefit trust funds, and the Unemployment Compensation funds. The purpose of the OAG's audit is to provide reasonable assurance that the Basic Financial Statements for the fiscal year ended September 30, 2003 are free of material misstatements. The OAG concluded that the Basic Financial Statements for the fiscal year ended September 30, 2003 are fairly presented in accordance with GAAP and issued unqualified opinions.

In addition to the annual audit of the SOMCAFR, the OAG also performs periodic financial statement and performance audits of the various State departments, agencies, and institutions of higher education. The Auditor General also has primary responsibility for conducting audits under the federal Single Audit Act of 1984. Pursuant to Michigan Public Act 251 of 1986, these audits are conducted biennially for applicable State departments, agencies and component unit authorities, and result in separately issued audit reports.

Management's Discussion and Analysis (MD&A): GASB Statement No. 34 requires that management provide a narrative introduction, overview, and analysis to accompany the Basic Financial Statements in the form of MD&A. This letter of transmittal is intended to complement MD&A and should be read in conjunction with it. The MD&A can be found immediately following the Independent Auditor's Report.

PROFILE OF THE GOVERNMENT

Reporting Entity: The State of Michigan reporting entity reflected in the SOMCAFR, which is described more fully in Note 1 to the basic financial statements, conforms with the requirements of GASB Statement No. 14, **The Financial Reporting Entity**. The accounting and reporting principles contained in Statement No. 14 are based primarily on the fundamental concept that publicly elected officials are accountable to their constituents. Further, Statement No. 14 provides that the financial statements should emphasize the *primary government* and permit financial statement users to distinguish between the primary government and its *component units*. Consequently, the transmittal letter, MD&A, and the financial statements focus on the primary government and its activities. Although information pertaining to the discretely presented component units is provided, their separately issued financial statements should be read to obtain a complete overview of their financial position.

Budgetary Reporting and Control: For the State primary government operating funds (i.e., the General Fund and annually appropriated special revenue and permanent funds), the State budgets projected revenues and expenditures and calculates fund balance for budgetary purposes in accordance with GAAP, except as identified below. Public Act 431 of 1984, as amended, prohibits the State from budgeting for an ending fund balance deficit in an operating fund. If an actual deficit is incurred, the Constitution and Act 431 require that it be addressed in the subsequent year's budget. If accounting principles change, Act 431 requires the State to also implement such changes in its budgetary process.

The budgetary "basis of accounting" used by the State primary government departs from GAAP only in ways that do not affect unreserved fund balance, and that do not impact most revenue and expenditure line items. Appropriations for nearly all line items, therefore, are made on a basis consistent with GAAP, which makes it possible for the State to use the central accounting system for both budgetary control and financial reporting purposes. The two variances between GAAP and the budgetary basis of accounting are: 1) the use of encumbrances for budgetary control purposes (which GAAP does not require), and 2) the timing of recording expenditures and liabilities for capital lease commitments on a "pay as you go" basis for budgetary purposes, rather than at lease inception as required by GAAP. Compliance with the final updated budget for the annually budgeted operating funds of the State primary government is demonstrated in the budget and actual comparative schedules and notes in the SOMCAFR. In addition, subsequent to the publication of the SOMCAFR, the State releases "Statewide Authorization Dispositions", a report providing line item appropriation details, the legal level of budgetary control, for the General Fund and budgeted operating funds.

Revenue and Spending Limitation Requirements: Under the State Constitution, total State revenues are limited to a percentage of total Michigan personal income. If the limit is exceeded by an amount less than 1%, the excess may be transferred to the Budget Stabilization Fund. If revenues exceed the limit by 1% or more, the amount in excess must be refunded to payers of personal income and single business taxes. The calculations necessary to determine the State's compliance with this requirement for fiscal year 2002-2003 are not final. For fiscal year 2001-2002, the most recent year for which final calculations are available, total State revenues subject to this limitation were less than the limit by approximately \$3.9 billion. The State expects that total State revenues subject to the limitation will not exceed the limit for fiscal year 2002-2003.

The State Constitution also requires that spending to local units of government be maintained at not less than a specified level of total State spending, originally determined to be 41.61% for the base fiscal year 1978-79. The originally determined percentage was recalculated, effective fiscal year 1992-93, reflecting the terms of a legal settlement agreement. The recalculated base year percentage is 48.97%. The calculations necessary to determine the State's compliance with this requirement for fiscal year 2002-2003 are not final. For fiscal year 2001-2002, the most recent year for which final calculations are available, the proportion of total State spending paid to local units of government was determined to be 64.3%, reflecting payments that exceeded the minimum required by \$3.8 billion. The State expects that payments to local units of

government will exceed the minimum requirement for fiscal year 2002-2003.

The State's status, with regard to these Constitutional provisions, is discussed more fully in Note 3 to the Basic Financial Statements.

ECONOMIC CONDITIONS AND OUTLOOK

Two years after the 2001 recession ended, the U.S. economy appears to have finally gained traction. While the buildup to war in Iraq slowed the U.S. economy, it has gained considerably since the end of major hostilities. The Conference Board's index of leading economic indicators has risen nearly every month since mid 2003. Similarly, the Institute for Supply Management's (ISM) indices signaled strengthening not only in the services sector but in the hard-hit manufacturing sector as well.

Until recently, the economic recovery had been missing two key elements: business investment growth and an employment recovery. By the end of 2003, these two previously missing elements appeared to be emerging. Between the first quarter of 2001 and first quarter of 2003, business investment had declined every quarter. However, business investment reported solid growth in the second quarter of 2003 and rapid growth in the third quarter. While moderating in the fourth quarter, investment is estimated to have reported its third straight quarter of growth.

Similarly, several recent indicators suggest that the U.S. jobs market, which has lagged nearly every other post-World War II recovery, may be on the mend. Wage and salary employment has risen four straight months through November. Initial unemployment claims have fallen below the 400,000 level and are trending downward. Over the past three months, the average hourly workweek has risen. While manufacturing employment continues to decline, those declines have moderated. Finally, ISM employment indices are now signaling increased hiring in both the manufacturing and services sectors.

2003 Michigan Economic Review: Michigan's economy has been disproportionately hit by the U.S. slowdown. The decline in Michigan wage and salary employment from its peak has been three times more severe than the national decline from its peak. In 2003, Michigan wage and salary employment declined by an estimated 1.1 percent, marking the third straight year of employment declines. Michigan's unemployment rate rose to an estimated 7.1 percent. Michigan wages and salaries income reported mild growth, compared with essentially flat growth in 2002. Personal income grew slightly faster in 2003 than in 2002.

The Department of Treasury and House and Senate Fiscal Agencies met on October 23, 2003, and reached a consensus for the 2003 and 2004 revenue and economic forecasts. The following summarizes the consensus economic forecast for 2004.

2004 U.S. Consensus Economic Outlook: Real GDP growth is forecast to grow 3.7 percent in 2004. The need to replace increasingly obsolete machinery, greater business optimism, higher profits and the December 2004 expiration of federal tax bonus depreciation will boost investment. Continued apprehension about the labor market will constrain consumption while low interest rates and stronger

income growth will help support consumer spending. With federal government spending moderating and state and local government declining slightly, government spending growth is expected to slow substantially in 2004.

Buoyed by continued incentive programs, light vehicle sales are forecast to remain nearly unchanged with projected 2003 sales of 16.5 million units and 16.6 million units in 2004. This compares with 16.7 million unit sales in 2002. Inflation will remain moderate throughout the forecast horizon. As measured by the consumer price index (CPI), consumer prices are expected to rise 2.3 percent in 2003 and 2.2 percent in 2004. Interest rates are forecast to remain low. The U.S. unemployment rate is expected to average 6.1 percent in both 2003 and 2004.

2004 Michigan Consensus Economic Outlook: While U.S. employment is forecast to rise beginning in the current quarter, Michigan employment is forecast to remain flat in the last quarter of 2003 and then rise only modestly over the balance of the forecast horizon. Continued weakness in manufacturing employment will constrain Michigan employment growth. Michigan wage and salary employment is forecast to rise by about 15,000 jobs each of the first three quarters of 2004 before rising by 21,000 jobs in the fourth quarter.

For 2003, employment is estimated to have declined 49,000 (1.1 percent) – the third straight annual Michigan employment decline. With modest growth in 2004, 2004 employment is forecast to average .6 percent higher than 2003 employment. Michigan's unemployment rate is forecast to average 7.1 percent in both 2003 and 2004.

The Department of Treasury and House and Senate Fiscal Agencies will again meet on January 14, 2004, for a Consensus Revenue Estimating Conference. At that conference, the agencies will reach consensus economic and revenue forecasts for 2004 and 2005.

MAJOR INITIATIVES AND FUTURE PROJECTS

Education: Despite an economic slowdown, education continues to be one of the most significant investments of State resources, with renewed emphasis placed on learning in the critical years from birth to age 5. More than \$14.4 billion, or 37 percent, of the State's overall budget is devoted to education in fiscal year 2003-2004. This includes funding for the K-12 system, universities, community colleges and student financial aid. In fiscal year 2002-2003, the State spent more on K-12 education than it spent on expenditures financed by General Fund general purpose revenues

Health Care: The delivery of health care services makes up the second largest share of State resources. While the state administers a variety of health care programs, the Medicaid program is the most extensive. In fiscal year 2002-2003, over \$2.3 billion in General Fund resources and over \$5.3 billion in federal funds were dedicated to this program. These funds allow the State to provide comprehensive health care services to over 1.3 million low-income Michigan citizens.

Job Creation and Economic Growth: On December 8, 2003, the Michigan Department of Labor and Economic Growth (DLEG) officially opened for business. With approximately 4,500 employees and an FY 2003-2004

budget of \$1.1 billion, DLEG's mission is to promote job creation and economic growth by centralizing and streamlining the State's job, workforce, and economic development functions within one department.

A Better Government: A number of successful initiatives have taken place during this calendar year that promotes a healthier, more efficient government. One of the most prominent is an initiative that involves all 55,000 State employees in an effort to define a shared vision and values. Currently underway, this effort is intended to strengthen State government by creating a workplace culture that is based on shared values that support the vision of a better government.

In addition, the State recruited seven "Executives on Loan" from major Michigan corporations and placed them in seven State departments. These executives brought best practices from the private sector to help streamline government and do what Michigan's best businesses do: improve services without increasing spending.

Government has also become more efficient by implementing measures that cut more than \$350 million from State government expenses. Reducing the number of cars in the State's fleet; urging every State department to cut costs with outside vendors; cutting down on travel costs; reducing cell phone use; and drastically lowering the amount of color copying are just a few examples of how government is more streamlined today.

FINANCIAL INFORMATION

The MD&A provides an overview of the State's financial activities addressing both governmental and business-type activities reported in the government-wide financial statements. In addition, MD&A focuses on the State's major funds: the General Fund, Budget Stabilization Fund, School Aid Fund, State Lottery Fund, and the Michigan Unemployment Compensation Funds. Fiduciary activities are excluded from the MD&A.

Cash Management and Investments: As discussed more fully in Notes 5 and 8 to the basic financial statements, the State Treasurer maintains the State's Common Cash pool, which is used by most State funds for short-term investments and to provide centralized control over disbursements. The total amount of pooled cash, which is primarily invested in prime commercial paper, amounted to \$2.2 billion at September 30, 2003, a decrease of approximately \$980.1 million (31.0 percent) from \$3.2 billion at September 30, 2002. Total investments amounted to \$50.3 billion at September 30, 2003, an increase of \$3.6 billion (7.8 percent) from \$46.7 billion at September 30, 2002. Pension (and other employee benefits) trust fund investments represent 92.9 percent of the total investments held by the State.

Debt Management: The State Constitution authorizes general obligation long-term borrowing, subject to approval by the Legislature and a majority of voters at a general election. General obligation bond issues totaled \$316.8 million during 2002-2003. The bonds provided financing for the Clean Michigan Initiative and school district loans, resulting in total general obligation bonds outstanding of \$1.4 billion at year-end.

Long-term bonds have been issued periodically for specific purposes, such as constructing new State and

university facilities and road and bridge construction. Funding of the debt requirements is to come strictly from designated revenue sources. Revenue dedicated bonded debt issuances, including that of the State Building Authority, totaled \$944.5 million during 2002-2003, resulting in a total of revenue dedicated debt outstanding of \$3.9 billion at year-end.

The State Constitution provides that the Legislature may authorize the issuance of short-term general obligation notes to assist in managing cash flows. Such borrowings are limited by the Constitution to 15% of undedicated State revenue received in the preceding year. The Constitution also requires that such borrowings be repaid before year-end. During fiscal year 2002-2003, the State issued and repaid short-term borrowings of \$1.2 billion.

Additional disclosures about the State's general long-term obligations are provided in Note 12 to the basic financial statements.

Pension Plans: The State Constitution requires the State to provide current funding of plan benefits for the State's defined benefit pension plans. Statutes provide for the amortization of unfunded prior service costs. In two of the four plans for which the State is responsible for providing funding, the enabling statutes for the plans contain provisions under which a shortfall in the legally required contributions will be corrected in succeeding fiscal years.

The State Employees' Retirement System (SERS) is the largest of the defined benefit plans for which the State is responsible for providing funding. Total assets of SERS at September 30, 2003 were \$9.2 billion, with net assets held in trust for pension and postemployment health-care benefits totaling \$9.0 billion. Additional disclosures relating to the State's pension funds are provided in Note 10 to the financial statements.

Risk Management: Risk management was established within the Department of Management and Budget in 1987 to improve the State's risk control policies and procedures. The unit's activities include analysis of and control over insurance coverage and risk exposure, and planning and implementing a statewide safety and health policy and program. The State is self-insured for many types of general liability and property losses. Additional disclosures on the State's risk management activities are provided in Note 24.

OTHER INFORMATION

Certificate of Achievement: The GFOA awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of Michigan for its SOMCAFR for the year ended September 30, 2002. The Certificate of Achievement is a prestigious national award, recognizing conformance with the highest standards for preparation of state and local government financial reports.

To be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. Such reports must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. The State has received a Certificate of Achievement for 16 consecutive years. We believe our

current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to the GFOA for review.

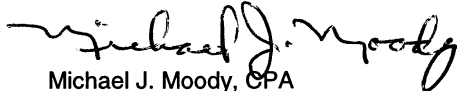
Acknowledgments: The preparation of this report requires the collective efforts of hundreds of finance personnel throughout the State, both individually and in teams from virtually all agencies and departments. For the second consecutive year, we published the CAFR within 90 days of

the fiscal year end; a feat yet to be accomplished by any other state. Achieving this was the result of the dedicated management and staff of the Financial Control Division, Office of Financial Management; the chief financial officers, chief accountants, and their staffs of all State agencies; and the management and staff of the Office of the Auditor General. We sincerely appreciate the dedicated efforts of all of these individuals.

Sincerely,



Mary A. Lannoye
State Budget Director



Michael J. Moody, CPA
Director, Office of Financial Management